

GOVERNMENT POLYTECHNIC BHUBNESWAR-2023



DEPARTMENT OF MODERN OFFICE MANAGEMENT

LECTURER NOTES

SEMESTER-2nd, PAPER- Cost Accounting

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COST ACCOUNTING

UNIT 2

Stock levels

1. Maximum level

The maximum level of stock is the level above which a business does not or cannot hold stock in its premises.

The maximum level of inventory could be described as the maximum capacity of a business to stock goods (inventory or raw material) in its store. It may be due to reasons like demand limitation of goods (in production or sales), the storage capacity of business, rationed funds etc. The 'maximum level of stock' is usually achieved when those goods arrive which were ordered at the 're-order level' of the stock.

$$\text{Maximum Level} = \text{Re-order level} + \text{Re-order quantity} - (\text{Minimum usage} \times \text{Minimum lead time})$$

Example 1

The Maha Cutlery Outlet sells dinner sets. It provides you the following information:

- Maximum demand: 200 per week
- Average demand: 160 per week
- Minimum demand: 145 per week
- Maximum lead time: 2 weeks
- Average lead time: 1.5 weeks
- Minimum lead time: 1.35 weeks
- Re-order quantity per order: 500 dinner sets
- Safety stock: 184 dinner sets

Required: Compute maximum level of stock of Maha Cutlery Outlet using above information.

Solution

$$\begin{aligned}\text{Maximum Level of Stock} &= \text{Reorder level} + \text{Reorder quantity} - (\text{Minimum usage} \times \text{Minimum lead time}) \\ &= \text{Reorder quantity} - (\text{Minimum usage} \times \text{Minimum lead time}) \\ &= *584 \text{ units} + 500 \text{ units} - (145 \text{ units} \times 1.35 \text{ days}) \\ &= 584 \text{ units} + 500 \text{ units} - 196 \text{ units} \\ &= 1,084 \text{ units} - 196 \text{ units} \\ &= 888 \text{ units}\end{aligned}$$

2. Reorder level of stock

It is also known as Reorder point or Ordering point. It is a preset level of stock or inventory at which the business places a new order with its suppliers to obtain the delivery of raw materials or finished goods inventory.

$$\text{Reorder level} = \text{Maximum weekly usage} \times \text{Maximum Lead time}$$

$$200 \text{ Units} \times 2 \text{ weeks} = 400 \text{ units}$$

3. Minimum Stock Level

A minimum stock level is the level of an item of material, below which the actual stock should not normally be allowed to fall. In other words, it refers to the minimum quantity of a particular item of material that must be kept in the stores at all times. The fixation of this level acts as a safety measure and hence, it is also known as 'Safety Stock' or 'Buffer Stock'.

Minimum Stock Level = Re-order Level – (Normal consumption per day/per week, etc. X Normal delivery time).

Example

Following example can be taken to understand the calculation of minimum stock level:

Normal consumption = 300 units per week

Normal delivery time = 7 weeks

Re-order level = 2,400 units.

The minimum stock level will be equal to:

= Re-order level – (Normal consumption per day/per week, etc. x Normal delivery time).

= 2,400 – (300 x 7)

= 2,400 – 2,100 = 300 units

4. Danger level

If for any reason, stock comes down below the minimum level, it is called danger level. When the stock reaches danger level, it is necessary to take urgent action on the part of the management for immediate replenishment of stock to prevent stock-out situation.

Average Consumption x Max. Re-order Period for Emergency Purchase

5. Average Stock level

The Average stock level is calculated such as:

Average Stock Level = Minimum stock Level + 1/2 of Reorder Quantity.

Lead Time:

A purchasing firm requires some time to process the order and time is also required by the supplier/vendor to execute the order. The time taken in processing the order and then executing it is known as lead time. It is essential to maintain some inventory during this period to meet production requirements.

VED Analysis:

VED stands for vital, essential and desirable. This analysis relates to the classification of maintenance spare parts and denotes the essentiality of stocking spares.

The spares are split into three categories in order of importance:

1. From the view-points of functional utility, the effects of non-availability at the time of requirement or the operation, process, production, plant or equipment and the urgency of replacement in case of breakdown.
2. Some spares are so important that their non-availability renders the equipment or a number of equipment in a process line completely inoperative, or even causes extreme damage to plant, equipment or human life.
3. On the other hand some spares are non-functional, serving relatively unimportant purposes and their replacement can be postponed or alternative methods of repair found. All these factors will have direct effects on the stocks of spares to be maintained.

V:

Vital items which render the equipment or the whole line operation in a process totally and immediately inoperative or unsafe; and if these items go out of stock or are not readily available, there is loss of production for the whole period.

E:

Essential items which reduce the equipment's performance but do not render it inoperative or unsafe; non-availability of these items may result in temporary loss of production or dislocation of production work; replacement can be delayed without affecting the equipment's performance seriously; temporary repairs are sometimes possible.

D:

Desirable items which are mostly non-functional and do not affect the performance of the equipment.

Perpetual inventory system

A **perpetual inventory system** is a method of inventory management that records real-time transactions of received or sold stock through the use of technology – generally considered a more efficient method than a periodic inventory system.

UNIT 3

Idle time

It is paid time that an employee, or machine, is unproductive that is a result of factors that can either be controlled or uncontrolled by management.

Overtime

It is the amount of time someone works beyond normal working hours.

Different methods of Wage Payment

1. Time Rate System
2. Piece Rate System
3. Incentive Wage System.

Time Rate System:

Under this method of wage payment, the workers are paid the wages on the basis of time. In this system of wage payment, the workers are paid the wages on the basis of time as, per hour, per day, per week, per fortnight or per month etc. This system does not consider the production of the employees during this time.

The amount of wages under this system is calculated as under:

Wages = Time spent by the worker × Rate of wages according to time.

Suitability of Time Rate System:

1. When it is not possible to measure the production in terms of units or in any other terms.
2. When the work is of high standard.
3. When it is not possible to divide the production into units.
4. When the production is of the nature that it requires efficiency more than the speed.
5. When the worker is under training.

Merits of Time Rate System:

1. Simplicity:

It is very easy to calculate the amount of wage under this system.

2. Certainty of the Amount of the Remuneration:

This system of wage payment provides certainty of the amount of wage payment to the employee. It develops the feeling of confidence and certainty among them.

3. High Quality of Production:

As this system of wage payment has no concern with quantity of production, quality of production produced by the workers under this system is very high.

4. Proper Utilization of the Factors of Production:

As this system is not related with speed, the workers perform their work in very confident manner. They make the best utilization of the factors of production.

5. Best System for Artistic Work:

This system of wage payment is most suitable for artistic work.

Demerits of Time Rate System:

1. Need of Intensive Supervision:

This system requires intensive supervision over workers. It increases the cost of supervision.

2. Lack of Incentive:

This system of wage payment makes equal payment to both the efficient and inefficient workers. Therefore, efficient workers do not get any incentive for more production.

3. Encouragement of Labour Unions:

This system encourages labour unions. Sometimes, these labour unions misuse their powers.

4. Misuse of Time by Workers:

Under this system of wage payment, the workers do not make proper Utilisation by their time.

5. Fall in the Quantity of Production:

Under this system of wage payment, the quantity of production decreases because the workers do not get any incentive for increasing the production.

6. High Cost of Production:

As the production is low and the payment to the worker is more, this system increases the cost of production.

7. It Kills the Efficiency of Workers:

As this system does not make any difference between efficient and inefficient workers, it kills the efficiency of efficient workers.

8. Increase in Cost Per Unit:

This system increases the cost per unit of production. Under this system, the cost per unit of production is uncertain because the quantity of production differs from time to time.

9. Difficult to Measure the Efficiency:

Under this system of wage payment, it is very difficult to measure the efficiency of workers because all the workers of equal status are paid the wages at equal rate.

Piece Rate System:

Under this system of wage payment, the workers are paid the wages on the basis of quantity and quality of work performed by them. Under this system, the rates of wages are determined according to quantity and quality of work and the workers are paid according to these rates.

The amount of wages to be paid to a worker under this system is calculated as under:

Wages = Units of production × Rate per unit.

Suitability of Piece Rate System:

This system of wage payment is very suitable in the following conditions:

1. When the work is of standard nature.
2. When the work can be measured easily.
3. When there is a great need of increase in the production.

Merits of Piece Rate System:

1. Incentive to More Work:

This system encourages the workers to do more and more work because they get their wages according to their work.

2. Proper Utilization of Machines:

Under this system, the workers use their machines and equipment with proper care because they feel that if their machine is out of order, their work will be held up and their wages will be low.

3. Increase in the Quantity of Production:

The system of wage payment gets more production because all the workers make their best efforts to increase the production.

4. Best Utilization of Time:

As the workers are paid according to their work, they make the best possible utilization of their time. They do not want to waste their time.

5. Decrease in the Cost of Production:

This system decreases the cost of production because the maximum production is done by the workers in the minimum time. It decreases the cost per unit of production also.

6. Decrease in the Cost of Supervision and Administration:

This system of wage payment minimizes the needs of supervision. It reduces the cost of supervision.

7. Easy and Simple:

This system of wage payment is very easy to understand and very simple to calculate.

8. Improvement in the Standard of Living of Workers:

Workers get more wages because they produce more. It increases their efficiency and productivity. It increases their remuneration also which improves their standard of living.

10. Measurement of the Efficiency of the Workers:

This system provides an opportunity to measure the efficiency of the workers.

Demerits of Piece Rate System:

1. Lack of Unity among Workers:

This system lacks the unity and mutual co-operation among workers. They feel themselves competitor to each other.

2. Loss of Workers on the Failure of Machines etc.:

It because of any reason, the machines fail or the power fails, the work of workers is held up and they lose their wages.

3. Misuse of the Factors of Production:

The workers do not pay proper attention towards the factors of production. They only want to increase the speed of production.

4. Adverse Effect on the Health of Workers:

This system motivates the workers to do more and more work. It affects the health of workers adversely.

5. Low Quality of Production:

This system of wage payment does not pay any attention on the quality of production. As a result of it the quality of production falls down.

6. Unsuitable for Artistic Work:

This system is not suitable for artistic work because artistic work cannot be paid only on the basis of quantity of production.

7. Uncertainty of Wages:

As the amount of wages depends upon the quantity of production, the actual amount of wages to be paid is always uncertain. The workers also cannot estimate their remuneration in advance.

Incentive Wage System:

There are two basic systems of wage payment—Time rate system and Piece rate system.

Both the systems have their merits and demerits. No system can be considered suitable for all times and under all circumstances. To maintain the merits of both the systems and to overcome the demerits of these systems, some experts have developed the systems of incentives wage.

These systems are also known as incentive wage systems, progressive wage system and bonus schemes etc. Under these systems, both the time and speed are considered as the basis of wage payment.

These systems provide incentives to the workers to produce more and more maintaining the quality as well. The workers are paid bonus or premium for the additional work. It is important to

note that almost all the systems incentive wages provide for minimum guaranteed wages to the workers.

Characteristics of an Ideal Incentive Wage System:

Important characteristics of an Ideal Incentive Wage System are as under:

1. It must be easy to calculate and to understand.
2. The standards of work must be determined on scientific basis.
3. It must establish direct relationship between efforts and remuneration.
4. It must give a guarantee of minimum wage to all the workers.
5. It must be in the interests of both the employers and the employees.
6. It must be flexible but stable.
7. It must be framed in the manner so that it may be used widely for all the activities of the enterprise.
8. It must be helpful in increasing the production as well as productivity.

Advantages of Incentive Wage System:

- i. There is increase in the prospect of workers to earn more
- ii. The scientific work study which is done before introducing a wage incentive plan brings about improvements in methods, workflow, and man-machine relationship and so on.
- iii. There is effective reduction in the supervision costs. Closer supervision of employees becomes unnecessary because workers become more responsible.
- iv. Employees are encouraged to become “inventive”. They invent and adopt ways and means to achieve their production targets with lesser exertion and lesser expense of energy. They come forward with new ideas and suggestions.
- v. There is improvement in discipline and industrial relations.
- vi. There develops a feeling of mutual co-operation among the workers .

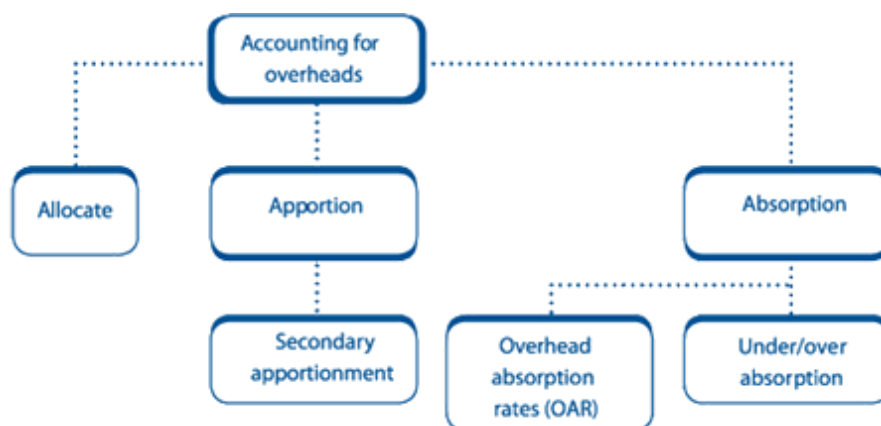
Effects of Incentive Wage System:

- i. There is tendency among the workers to sacrifice quality for the sake of quantity.

- ii. Employees very often ask for compensation whenever production flow is disrupted due to the fault of management.
- iii. Unless greater vigilance is exercised there is a danger of workers disregarding safety regulations.
- iv. Unless a maximum ceiling on incentive earning is fixed some workers tend to overwork and undermine their health.
- v. Jealousies may arise among workers because some are able to earn more than others.
- vi. The introduction of a system by results increases the amount and cost of clerical work since it involves considerably more bookkeeping. This is particularly true when the production is subdivided into many processes.

UNIT 4- Accounting for overheads DISTRIBUTION OF OVERHEADS

- PRIMARY DISTRIBUTION
 - ALLOCATION & APPORTIONMENT
- SECONDARY DISTRIBUTION
 - RE-APPORTIONMENT
- FINAL DISTRIBUTION
 - ABSORPTION



1 Direct and indirect expenses

Direct expenses are expenses that can be directly identified with a specific cost unit or cost centre. There are few examples of direct expenses but royalties paid to a designer or fees paid

to a subcontractor for a specific job could be classed as direct expenses.

- Direct expenses are part of the prime cost of a product.

Indirect expenses cannot be directly identified with a specific cost unit or cost centre.

- For example, the cost of renting a factory where shirts are manufactured is classified as an indirect cost because it would be impossible to relate such costs to shirts only, if other clothes, such as dresses and suits were also made in the same factory.
- Indirect expenses are also known as overheads.

Concept Of Allocation Of Overhead ,Apportionment Of Overheads and Absorption of overheads

Allocation Of Overheads

Overheads are common costs incurred for the benefits of a number of costs centers or cost units. Therefore, they can not be identified and allocated directly to a particular unit of output. As such, they are to be allocated among the units of output of a particular department or a number of departments or cost centers.

Allocation of overheads is the process of charging overhead costs to a particular department or cost center. It is the allotment or assignment of an overhead cost to a particular cost unit. If the overhead cost is associated with a single department or cost center, the whole amount is charged or distributed among the units of output of that particular department. For example, the whole amount of repair and maintenance expenses for a machine is charged or allocated to that department where the machine has been installed.

Apportionment Of Overheads

Distribution of an overhead cost to several departments or cost centers is known as apportionment of overheads. It is the process of charging or apportioning costs to a number of cost centers or cost units. If a given cost is common to two or more departments or cost centers, such cost should be apportioned or divided among these departments on an equitable basis.

For example, the amount of factory rent should be apportioned to all the departments. Similarly, the amount of remuneration of the general manager should be distributed to the production, administration and marketing departments as the general manager is associated with all these departments.

Absorption of overheads

Absorption of overheads refers to charging of overheads to individual products or jobs. It is a process of distribution of overheads allotted to a particular department or cost centre over the units produced. The absorption of overhead is done by applying overhead absorption rates. The overheads allocated or apportioned over different cost centres or cost units are again absorbed into unit cost on some equitable basis.

Primary Distribution/ Apportionment

Apportionment is also called primary distribution. The overheads are apportioned to the departments on certain basis.

OverheadBasis

1. Rent & Other Related Expenses	Floor Area
2. Lighting & Heating	
3. Fire Precaution Service	
4. Air Conditioned	
5. Canteen Expenses	No. Of Employees Or No. Of Workers.
6. Labour Welfare	
7. Time-Keeping	
8. Personnel Office	
9. Supervision	
10. Compensation To Workers	Direct Wages
11. Holiday Pay	
12. Esi & Epf	
13. Genneral Overhead	Direct Wages/Direct Labour Hours/ Machine Hours
14. Depreciation On Plant And Machinery	Value of Capital / Value of The Assets
15. Repair & Maintenance	
16. Insurance	
17. Power/Steam Consumption	Technical Estimate
18. Internal Transport	
19. Managerial Salary	
20. Lighting Expenses	No. Of Light Points
21. Electric Power	Hp Of Machine Used/ No. Of Machine Hours
22. Managerial Salary	
23. Material Handling	The Value/Quality/ Volume Of Materials
24. Stores Overhead	

EXAMPLE:1 FROM THE FOLLOWING PARTICULARS PREPARE AN OVERHEAD PRIMARY DISTRIBUTION SUMMARY.

	A	B	C	D	E
1. DIRECT WAGES	2000	3000	4000	1000	2000
2. DIRECT MATERIAL	1000	2000	2000	1500	1500
3. STAFF (no.)	100	150	150	50	50
4. ELECTRICITY (kw/hrs)	4000	3000	2000	1000	1000
5. LIGHT POINTS	10	16	4	6	4
6. ASSET VALUE	60000	40000	30000	10000	10000
7. AREA (square yards)	150	250	50	50	50

8. EXPENSES FOR THE PERIOD:

<u>ITEMS</u>	<u>AMOUNT in Rs</u>
POWER	550
LIGHTING	100
STORES	400
AMENITIES TO STAFF	1500
DEPRECIATION	15000
REPAIR & MAINTAINANCE	3000
GENERAL OVERHEADS	6000
RENT & TAXES	275

Items	Basis of Apportionment	Amount	A	B	C	D	E
POWER	ELECTRICITY (kw/hrs) (4:3:2:1:1)	550	200	150	100	50	50
LIGHTING	LIGHT POINTS (5:8:2:3:2)	100	25	40	10	15	10
STORES	DIRECT MATERIAL (2:4:4:3:3)	400	50	100	100	75	75
AMENITIES TO	STAFF (no.)(2:3:3:1:1)	1500	300	450	450	150	150

STAFF							
DEPRECIATION	ASSET VALUE(6:4:3:1:1)	15000	6000	4000	3000	1000	1000
REPAIR & MAINTAINANCE	ASSET VALUE(6:4:3:1:1)	3000	1200	800	600	200	200
GENERAL OVERHEADS	DIRECT WAGES(2:3:4:1:2)	6000	1000	1500	2000	500	1000
RENT & TAXES	AREA (square yards) (3:5:1:1:1)	275	75	125	25	25	25
	TOTAL	26825	8850	7165	6285	2015	2510

Power is distributed to all departments on the proportion basis of electricity. Likewise all the expenses are distributed to the departments on the basis of apportionment (proportional).

Methods of Overhead Absorption:

i. Production Unit Method:

Under this method, overhead absorption rate is calculated by dividing the overhead cost by number of units produced or expected to be produced as shown below:

OVERHEAD RATE= Production Overhead/ No. of units produced in that Dept.

This method is suitable when equal importance is given to both material and labour.

For example, the budgeted overhead is Rs. 2,00,000 p.a. and the budgeted production is 50,000 units p.a. (200000/50000=Rs4per unit)

ii. Percentage of Direct Material Cost Method:

Under this method overhead is absorbed based on the actual or predetermined absorption rate calculated by expressing the overhead cost as percentage of direct materials for the same period.

The absorption rate is calculated as follows:

Overhead rate=(production overhead/direct material cost) x 100

For example, budgeted overhead is Rs. 1,00,000 and the budgeted direct material cost is Rs. 4,00,000, then overhead absorption rate is:
(100000/400000)x 100=25%

iii. Percentage of Direct Labour Cost Method:

Under this method, overhead absorption rate is calculated by expressing the overhead expense to be absorbed as a percentage of cost of direct labour for the same period, as shown below:

$$\text{(Budgeted or actual overhead cost/Budgeted or actual direct labour cost) x 100}$$

For example, the budgeted overhead is Rs. 1,00,000 and the budgeted direct labour cost is Rs. 5,00,000.

$$(100000/500000) \times 100 = 20\%$$

iv. Percentage of Prime Cost Method:

This method is a combination of both direct material cost and direct labour cost method. The overhead absorption is calculated as follows:

$$\text{Overhead rate} = (\text{production overhead/prime cost}) \times 100$$

This method is suitable where equal importance is given to both the material and labour for the purpose of calculation of overhead.

For example, the budgeted overhead is Rs. 2,00,000 and the budgeted prime cost is Rs. 8,00,000.

$$(200000/800000) \times 100 = 25\%$$

v. Direct Labour Hour Rate Method:

Under this method, overhead absorption rate is calculated by dividing the overhead with the number of direct labour hours.

$$\text{Overhead rate}$$

$$\text{Production overhead/Direct labour hours during a period.}$$

This method is suitable where most of the work is done manually & where production is not uniform.

For example, the budgeted overhead of production centre is Rs. 2,00,000 and the budgeted direct labour hours for the period is 40,000.

$$200000/40000 \text{ direct labour hour} = \text{Rs}5 \text{ per direct labour hour}$$

vi. Machine Hour Rate Method:

CIMA defines Machine Hour Rate as an “actual or predetermined rate of cost apportionment or overhead absorption, which is calculated by dividing the cost to be apportioned or absorbed by a number of hours for which a machine or machines are operated or expected to be operated.”

The machine hour rate is calculated as follows:

Budgeted or actual overhead/Budgeted or actual machine hour during the period

For example, the budgeted production overhead is Rs. 3,00,000 and estimated machine hours is 15,000.

Rs 300000/15000 machine hours= Rs 20 per machine hour

UNIT 5

What Is Contract Costing? – Definition

Contract costing is the method of costing which is applied in a business where separate contracts of non-repetitive nature are undertaken. According to Sharie, “Contract or terminal cost accounts are applicable to a concern which makes specific contracts and requires to know the cost of each.”

Explanation

Contract costing is a special form of job costing wherein big jobs are involved which requires considerable time to complete and comprises a lot of activities. Herein a separate account is opened for each contract in the Contract Ledger (or in General Ledger). The account is debited with all direct and indirect expenses and is credited with the amount of contract price on completion of the contract. The balance of this account is transferred to Profit and Loss Account. However, if the contract is not completed before the end of the accounting period, a reasonable amount of profit (or logs) is transferred to Profit and Loss Account.

Features Of Contract Costing

The main features of Contract Costing may be summarized as follows:

1. Contracts are executed at contract site away from executor’s or contractor’s premises.
2. Contracts are jobs of large size and may continue over more than one accounting period.
3. Each contract is treated as a separate unit of cost for the purpose of cost ascertainment.
4. The contracts are executed as per the specifications given by the contractee.

5. Since the work is executed at the contract site, most of the items of cost to be incurred are direct in nature.
6. The contract is executed by the contractor for some agreed amount of consideration known as Contract Price.
7. The payments by the contractee are made to the contractor in installments on the basis of the extent of the work already completed by him and certified as complete by contractee's engineer or architect.

Objects Of Contract Costing

The main objects of Contract Costing are:

- (i) to ascertain the total cost of a contract, and
- (ii) to ascertain the profit or loss on the contract.

PROCEDURES FOR RECORDING OF COST OF CONTRACT:

The following points highlight the seven main procedures for recording of cost of contract. The procedures are: 1. Materials 2. Labour or Wages 3. Site Expenses 4. Indirect Expenses 5. Plant and Machinery 6. Sub-Contracts 7. Extra Work.

CONTRACT LEDGER																				
Form No.				Contract Price						Terms of Payment										
Contract No.				Site						Retention Money										
Completion Date				Remarks						Work Certified										
										Date Rs.										
										Date Rs.										
<i>Dr.</i>							<i>Cr.</i>													
Date	Particulars	Folio	Materials	Wages	Direct Expenses	Plant	Sub-contract Costs	Establishment Charges	Total	Date	Particulars	Folio	Materials	Wages	Direct Expenses	Plant	Sub-contract Costs	Establishment Charges	Total	

1. Materials

The value of materials used is debited in the concerned contract account. Materials may be specifically purchased from the open market, issued from the stores, transfer from other contracts or supplied by the contractee himself. If materials are returned to stores, the value of materials is credited in the concerned contract account.

Sometimes, materials may be transferred from one contract to another. If so, the value of materials is debited in the receiving contract account and credited in the transferring contract account. Whenever the materials are purchased from the open market, the values of materials are debited in the concerned contract account.

Similarly, if materials are issued from stores, the concerned contract account is debited and the stores control account is credited. Sometimes, some materials may be stolen or destroyed by fire, the value of materials is credited in the concerned contract as stores account and the same is transferred to profit and loss Account.

2. Labour or Wages:

Generally, the contract is carried on only at the site of the contractee i.e., customer not within the company premises. Hence, labour is engaged at site to work on the contract. The amount paid to workers is wages which is directly debited in the concerned contract account. The details of information regarding wages are obtained from the records of time sheet and wages sheet. Equitable base method is usually adopted to apportion the wages of supervisors working on two or more contracts.

Likewise, the overheads are also apportioned on suitable basis. The accrued wages and outstanding expenses are calculated at the end of the accounting period and debited in the concerned contract account.

3. Direct Expenses

The direct expenses are debited in the concerned contract account as and when they are incurred. Examples of direct expenses are hire charges paid for the plant procured from outside, sub-contractor's charges, architect's fees, electricity, insurance and the like.

4. Plant and Machinery

The plant and machinery is treated in two ways. Under first method, the full value of plant and machinery is debited in the concerned contract account if the plant and machinery is specifically purchased for the contract. At the end of contract, the plant and machinery may be sold out in the market if it is not required further. If so, the sale proceeds are credited in the concerned contract account.

Sometimes, the plant and machinery may be required further, if so, the depreciated value or revalued amount of plant and machinery is credited in the concerned contract account. The net effect is that the contract account is debited with the amount of depreciation.

Under second method, the contract account is debited with the amount of depreciation of plant and machinery. The plant and machinery may be purchased specifically from the open market or issued from the stores. The amount of depreciation is calculated on the basis of daily use or hourly basis. Sometimes, a plant is procured on hire basis, if so, only hourly charges are debited in the contract account.

5. Overheads

Indirect costs cannot be directly charged to any contract account. These costs are apportioned to all the contract accounts only on the suitable basis. These are called as overheads. The term overheads includes payment made to engineers, supervisors, architects, managers, store keeper, central office, administrative expenses like staff salaries, telephone expenses, postage, rent, stationery, advertisement expenses etc.

6. Sub-Contracts:

Generally work of a specialised character e.g., the installation of lifts and special flooring, is passed out to any other contractor by the main contractor. In such cases the work performed by the sub-contractors forms a direct charge to the contracts concerned. Subcontract cost will be shown on the debit side of the Contract Account.

7. Extra Work:

In most of the contracts additional work or variations of the work originally contracted for, are required by the contractee. The additional work, being outside the original contract, will be subject to a separate charge. If the additional work is quite substantial, it should be treated as a separate contract and a separate account should be opened for it.

If it is not very substantial, expenses incurred upon extra work should appear on the debit side of the contract account as 'cost of extra work' and the extra amount which the contractee has agreed to pay should be added to the contract price.

Cost plus contract is one wherein the contractee agrees to Pay to the contractor the cost price of the work done on the contract plus an agreed amount or percentage thereof by way of different overheads and profit.

Sub-contracts. The contractor (if thinks proper and allowed to do so by the agreement entered into) may entrust some portion of the work to be done by one or more than one sub-contractor. The cost in this connection is the direct charge on the contract and is treated as such in the contract costing.

Escalation Clause. In a contract agreement, there is a usual practice of making a provision for the escalation clause the contractor is interested in safeguarding himself against any charge in the price level. The agreement itself specifies the procedure for the calculation of adjustment in order to avoid all disputes etc.

What is process costing?

A manufacturing unit that can differentiate its processes and produces a standard product will use process costing method to determine cost of production. This is done by allocating all process cost to the total units produced.

In simple words, if an unit passes through different processes and the processes are easily distinguishable then the cost of the unit will be cost of process that it goes through.

In process costing a separate account is opened for every process and on completion of the process the cost is transferred to the next process.

Illustration

A paper manufacturing unit has the following processes

- Making pulp
- Beating
- Pulp to paper
- Finishing

It is used in mass production industries producing standard products like steel, sugar chemicals etc.

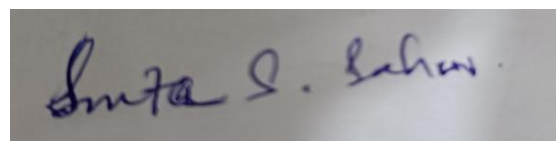
Features:

- Production is continuous and the final product is the consequence of all the processes.
- Products are standardized and homogeneous.
- The finished product of one process becomes the raw material for the next process.
- Some loss of materials in process is unavoidable.

Normal Loss: The amount of loss which cannot be avoided because of the nature of material or process. Such a loss is quite expected under normal condition. e. g, evaporation, unavoidable spoiled quantities, withdrawals for tests.

Abnormal loss: Abnormal loss is due to carelessness, accidents, machine breakdown and other abnormal reasons. Like normal loss abnormal loss is not absorbed by good production rather it is transferred to Costing Profit and Loss account.

Abnormal Gain: When the actual loss is greater than normal loss it is known as abnormal loss. When actual loss is smaller than than the normal loss it is known as abnormal gain.



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